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The history of economic policy is marked by lengthy periods of gradual evolution punctuated now and then by more dramatic changes. When they occur, these dramatic episodes usually do not represent a reversal in the apparent trends in policy but rather a rapid acceleration in these trends which, for various reasons, may have been slow to reflect changing economic and political circumstances. Thus, what at first blush may look like a new policy departure in another light may be seen as overdue catching-up, the pressure of economic and political reality having finally built up to the point where it bursts through the obstacles that have unduly constrained the pace of policy adjustment.

This general pattern is evident in the recent history of U.S. policies vis-a-vis the rest of the world. The policy framework that emerged after World War II was based on an implicit bargain between the U.S. and its Western allies (including Japan) whereby the U.S. assumed most of the burden of defending the West, made available substantial resources for international reconstruction and development and provided relatively easy access to the rich U.S. market in return for strong support in advancing U.S. interests around the world. Underpinning this arrangement was the assumption that through co-operation and closer economic and political integration the interests of all participants in the bargain would be served and that the West as a whole would be strengthened. With the passage of time the basis of this implicit bargain, and its rationale, has been eroded by changing circumstances. As a consequence, policies in the U.S. and elsewhere have been modified. For the most part, however, policies have adapted slowly with the result that in many cases they had become unrealistic and unsatisfactory. President Nixon's dramatic initiatives during 1971 in both the political and economic spheres have broken through the heavy crust of inertia constraining policy adjustments. In these terms, these initiatives are generally to be welcomed on the ground that they open the way to a major and long over-due up-dating of policies in several areas. The main causes for concern are: (i) whether the policy changes adopted are appropriate to present and prospective circumstances, and (ii) how to prevent the current open-season on policy from being exploited by narrow national vested interests and the moss-back fringe found in every country.

Economic Policy

Cause for concern on both counts is evident in the area of international economic policy. It has been increasingly apparent in recent years that Europe and Japan now are in a position to shoulder most, if not all, of the burden of providing for their own defense and that the share of this cost that the U.S. continues to bear - admittedly at its own volition - is difficult, if not impossible, to justify. It has also been evident that the international monetary system required more basic reforms than were being contemplated prior to mid-1971 in order to provide for greater flexibility in foreign exchange rates and easier balance of payments adjustment. Similarly, in the area of foreign aid, the evidence accumulated over the past decade has raised serious doubts about the effectiveness of aid in achieving its alleged objectives; nor has it been clear that developed countries other than the U.S. should not supply a larger share of total aid flows. In the field of foreign investment the last decade has seen an enormous growth in international capital flows, the development of much closer integration among international capital markets and growing concern about the economic and political implications of these large international capital flows - especially direct investment flows and the growth of the large multinational enterprise. Finally, the concept of a freer, multilateral, non-discriminatory trade and payments system, which was the foundation on which post-war international economic policy was based, has been challenged by the advent of the European Economic Community, by the emergence of a wide range of quantitative controls (especially for agricultural commodities and so-called "low-cost" imports), by the demand for tariff preferences by the less-developed countries, by the special status claimed as semi-industrialized countries by countries like Canada and Australia in recent trade negotiations and by the apparent reluctance of most countries to negotiate further reductions in trade and payments barriers.

The institutional framework within which these policies have been developed internationally since the War has consisted mainly of the NATO, the GATT, the IMF, the IBRD, the UN and its agencies, and the O.E.C.D. together with national agencies in various countries. Although there has been prolonged discussion of these matters in these international fora over many years, the progress made in achieving significant changes in policy has been slow and hesitant. Indeed, at times these institutional arrangements, rather than facilitating policy adjustment, have seemed to slow it down. Meanwhile the U.S. has continued to support large balance of payments deficits and a continuing drain on its foreign exchange reserves. The failure of the European countries, Japan, and the rest of the world to recognize the realities of the situation in time and to adopt policies in co-operation with the U.S. that conformed more closely to underlying realities made it almost inevitable that eventually the U.S. would proceed unilaterally as it did last August. And proceeding unilaterally as it did, the U.S. probably adopted policies that were more narrowly nationalistic than they would have been had its partners been more forthcoming earlier, making it feasible to work out more realistic policies on a co-operative basis. In this sense post-war international co-operation failed in that it did not prove feasible to adjust policies satisfactorily in conformity with changes in underlying economic circumstances on a co-operative basis. In the end, one country operating on its own cast the die, forcing everyone else to cope as best they could. For those who have looked to international co-operation as a method of curbing narrow nationalism in economic affairs, the experience of the past few years is somewhat disappointing.

This view of recent developments, which has been particularly stressed in the U.S., can of course be overemphasized: the U.S. itself over the years has followed highly protectionist policies in several areas and more recently protectionist sentiment has been increasing. U.S. barriers to trade in textile and agricultural products provide prime examples of long-standing restrictive trade policies. Indeed, U.S. agricultural policy may be as protectionist in its effects on international trade as the Common Market's agricultural policies which have attracted much criticism in recent years. Moreover, the international community has been impressed by the failure of the U.S. Congress to empower the Administration to negotiate further tariff reductions.

Proceeding on its own in August, the U.S. had several options. It needs to be emphasized that many of these options, as pointed out below, would have given freer reign to autarky and would have been more damaging to a liberal international regime of trade, payments and investment than the policies that actually were adopted. This may be taken as an encouraging feature of recent developments: proceeding on its own and faced with strong isolationist and protectionist pressures domestically, the U.S. opted for policies that were considerably more liberal than they might have been. This said, it nevertheless also remains true that some of the measures adopted represented a step backward in the development of more liberal economic policies for the world.

The international policies adopted or proposed for adoption by the U.S. in mid-August consisted of the following major components:

a) suspension of the convertibility of U.S. dollars into gold and other reserve assets, thereby repudiating the fixed exchange-rate, gold-exchange standard established after World War II under the IMF;
b) imposition of a temporary 10 per cent surtax on a wide range of imported products;
c) provision of an accelerated investment tax credit of 10 per cent (reduced to 5 per cent after August, 1972) on machinery and equipment purchased from domestic suppliers, but not on machinery and equipment purchased from foreign suppliers as long as the surtax applies;
d) establishment of a Domestic International Sales Corporation (DISC) which will provide a substantial direct tax incentive to U.S. companies to cater to foreign demand by exporting from the U.S. rather than by establishing production facilities abroad.

These international measures were combined with a series of domestic measures designed to stimulate economic activity, to increase employment and to restrict wage and price inflation.

The suspension of convertibility of U.S. dollars into gold in effect meant that the international value of the U.S. dollar was determined by the private demand for and supply of U.S. dollars in foreign exchange markets together with the willingness of foreign central banks to hold U.S. dollars. Given the need to correct a balance of payments problem that now has been evident for almost a decade and that has seriously constrained domestic policy options, the main alternatives open to the U.S. were: i) to devalue the dollar by raising the price at which it was prepared to convert dollars into gold; ii) to depreciate the value of the U.S. dollar relative to other currencies by renegotiating foreign exchange parities; iii) to validate existing parities by following restrictive domestic economic policies that would have forced domestic prices and costs back into line with international prices and costs; and iv) to adopt a variety of import restrictions, export promotion policies and restrictions on foreign investment outflows that would have forced its international payments into balance at existing parities. Without going into the implications of these various options, suffice it to say that many economists would agree that the suspension of convertibility was preferable to these other options from the standpoint both of maintaining a relatively liberal regime for international trade and investment and of maintaining high levels of employment throughout the world. Moreover, the fears expressed in the past that a floating exchange rate would result in wide fluctuations in exchange rates and/or a reduction in foreign trade and investment because of uncertainty about the rate proved to be largely groundless. From August to December the exchange rates of most industrialized countries were largely determined by market forces - admittedly with some central bank intervention - and the system worked reasonably well.

The illiberal, protectionist features of the August measures emanated mainly from the surtax, the discriminatory "buy American" tax changes and the DISC proposal. All of these measures were straight-forward "beggar-thy-neighbour" policies with few, if any, redeeming graces. Although nominally applicable to all U.S. trading partners, in fact the impact of these measures on various countries differed greatly and their potential impact on Canada was relatively greater than on any other country because of the size and pattern of trade and investment between Canada and the U.S. This points to the first of several apparent inconsistencies arising from these measures. Few contended (and the December settlement implicitly recognized the point) that Canada's exchange rate in terms of U.S. dollars needed realignment: Canada adopted a floating rate in May, 1970 and since then the rate has appreciated by over 7 per cent. Moreover, since 1969 the inflow of capital from the U.S. has decreased sharply implying, ipso facto, a sharp decrease in our current account deficit with the U.S. These changes went a considerable way to meeting U.S. objections in the late 1960's, and voiced even today, that Canada in the past has relied too heavily on U.S. capital and should finance more of its investment out of domestic saving. (How permanent this change in Canada's international accounts remains an open question however: it is quite possible that as the economy moves closer to full employment the current account deficit will again increase along with an increase in capital imports). Why then should the U.S. have applied these protectionist measures against Canada when the main purpose of these measures was alleged to be to force others to realign their currencies and to liberalize their trade and investment policies?

The list of demands about which the U.S. apparently wishes to bargain with Canada included the following items, with the major emphasis on the first three:

1. An expansion of the auto pact to eliminate the prohibition on trade in second-hand cars, to include duty-free trade for other types of vehicles, to eliminate the safeguards intended to ensure the continuation of an appropriate share of total North American production within Canada and to allow for duty-free trade by dealers and consumers as well as by manufacturers of automobiles.

2. An increase in the size of the duty-free allowance for Canadian residents returning to Canada from visits to the U.S.

3. An increase in Canadian defense purchases from the U.S. and equity of

treatment under defense production sharing arrangements. (At present there is no price discrimination between Canadian and U.S. suppliers as far as U.S. defense purchases are concerned; in the case of Canadian defense purchases, however, Canadian suppliers are given up to a 10 per cent preference on price relative to U.S. suppliers).

4. A revision of current tax proposals which call for foreign-controlled companies in Canada to pay higher tax rates on the first $50,000 of profit than Canadian-controlled firms;

5. A unilateral reduction in Canadian tariffs on manufactures because Canadian tariffs on manufactured and semi-manufactured products are said to be among the highest in the developed world;

6. A loosening of pressures against foreign-controlled companies.

Canada, one need scarcely emphasize, has had little difficulty in coming up with a countervailing list of grievances against U.S. protectionist measures that seriously restrict Canadian exports to that country.

While it may well be useful to have such lists placed on the negotiating table and for hard bargaining to be undertaken to reduce the restrictions and distortions that apply to trade and investment across the border, the suggestion that the surtax, DISC and the discriminatory tax changes were applied against Canada in the interest of promoting freer trade and investment can only be received with a cynical smile. And if, in fact, these measures were put forward in good faith with this objective in mind, one can only wonder at the naivety and incompetence of those who proposed a policy based on the proposition that the way to speed up forward progress is to move rapidly backwards. This represents a second major inconsistency in these policies as far as Canada is concerned. Even a rudimentary appreciation of Canada's political sensitivity and the history of commercial policy suggests that this approach was more likely to harm than to enhance progress towards freer trade and investment policies. Moreover, in any negotiation between the U.S. and Canada on outstanding grievances the U.S. necessarily is in a very strong bargaining position and probably has more to lose than to gain by starting the proceedings with a salvo of new protectionist measures.

The DISC proposal poses further inconsistencies for both the U.S. and Canada. On the one hand, the U.S. argues for a lessening of Canadian pressure on U.S. corporations to favour Canadian interests and for a greater emphasis on allowing corporate decisions to reflect underlying economic circumstances; it is concerned about the treatment accorded U.S. investment in Europe and elsewhere; and in the past it has actively attempted to open Japan and other countries to greater U.S. investment. On the other hand, DISC provides a tax incentive to deter U.S. investment abroad and attempts to distort investment and trade decisions in favour of U.S. interests. Moreover, where before such safeguards as those included in the auto pact may have seemed unnecessary and undesirable to many Canadians, the willingness of the U.S. to use its power to distort investment and trade in its direction has made more valid the fears on which these safeguards are based and has given them greater legitimacy. On the Canadian side, the protectionist measures adopted by the U.S. may have strengthened the hand of economic nationalists and therefore have made it more difficult to pursue liberal trade and investment policies. Even more paradoxical, the DISC proposal fits in exactly with the demands of those nationalists who long have sought policies to reduce U.S. investment in Canada. The mind boggles at finding Mel Watkins and John Connally sharing the same mistress.

Another inconsistency arising from these protectionist measures, and enhanced by the depreciation of the U.S. dollar relative to foreign currencies, is that all of these measures had an inflationary effect on domestic U.S. prices and costs and therefore were at odds with the domestic measures adopted to curb price and cost inflation.

Finally there is gross inconsistency between the adoption of a floating exchange rate, the emphasis on reducing U.S. investment abroad and the continued talk by U.S. policy-makers about a turn-around in the U.S. trade account balance of some \$12 billion - from a \$6 billion deficit to a \$6 billion surplus. Such a turn-around requires not only a substantial trade surplus but also substantial capital exports if the U.S. dollar is to remain at its present depreciated level. And for Canada it implies a return to a substantial current account deficit financed by substantial imports of capital, which is inconsistent with past U.S. complaints about our excessive reliance on U.S. capital. Alternatively, efforts to bring about such a turn-around imply a substantial appreciation of the U.S. dollar on international currency markets from current values, thereby undoing the depreciation of the U.S. dollar sought in recent months. These inconsistencies are further compounded by the failure to recognize that as a mature creditor country with large foreign investments it is necessary for the U.S. to accept some decline in its trade balance as a return flow of interest and dividends materializes from past investments. Failure to do so either implies that countries like Canada will be unable to repay past debts without incurring new ones or in one way or another they will repudiate past debts.

How then can one explain the adoption of policies that seem so riddled with inconsistencies in relation to the alleged objectives of the policies? The official U.S. answer is that the temporary surtax and discriminatory investment tax credit measures were simply bargaining ploys invoked to force a realignment of currencies. When this was achieved in mid-December, the temporary measures were rescinded. It is argued further that without this bargaining ploy the arrangements worked out in December could not have been achieved as effectively. This interpretation is suspect for at least two reasons. First, it is far from clear that the surtax and discriminatory tax credit provided the main bargaining leverage by the U.S. on its trading partners: the strong desire by Europe and Japan to re-establish a new set of exchange rate parities was probably much more important; and, as argued below, these temporary measures may actually have reduced the bargaining leverage of the U.S. Secondly, these temporary measures interfered with ascertaining what the new parities should be.

A second interpretation is that these protectionist measures were applied with one central objective in mind: to create domestic employment at the expense of employment abroad. This is consistent with the domestic measures adopted in August. It is also consistent with the unwillingness of the U.S. to exempt Canada from these measures, even though the rationale initially provided was inapplicable to Canada, since as its largest trading partner Canada offered more scope for exporting unemployment from the U.S. than any other country. Only when the U.S. came to realize the serious international political and economic consequences likely to result from these protectionist measures, as these became increasing evident in the course of discussions with its trading partners, was the U.S. prepared to write off the surtax and the discriminatory tax credit as aids to domestic employment. It may be argued further that the threat of these consequences in fact impaired the U.S. bargaining position; without the threat emanating from these protectionist measures, the U.S. might have been able to attain a more satisfactory monetary settlement than the short-run settlement actually achieved in December.

A further reason may have contributed to U.S. unwillingness to exempt Canada from the August measures. Both the surtax and the discriminatory feature of the investment tax credit were advanced as temporary measures required for balance of payments reasons and a special exemption for Canada might have impaired the U.S. bargaining position with Europe and Japan. U.S. officials argued that a special exemption for Canada would have contravened GATT regulations. They pointed out further, as evidence of their recognition of GATT rules, that the decision to eliminate the excise tax on both domestic and imported automobiles was influenced by the fact that discrimination would have violated GATT regulations. It is apparent, nevertheless, that the U.S. as well as other countries have broken international rules in the past and also that the entire package of August measures contravened both the letter and the spirit of IMF - GATT rules. The U.S. justified breaking these rules on the practical ground that the August measures were less illiberal than the exchange controls and import quotas permitted under the IMF - GATT rules for countries that find their international payments position in fundamental disequilibrium. Whether on practical grounds the U.S. might have gone the further step of exempting Canada without significantly affecting its bargaining position vis-à-vis Europe and Japan is a question that remains in doubt.

Canada's Special Status

Canada never really fitted into the implicit bargain underlying relations between the U.S. and its allies after World War II, referred to at the outset. Because of our unique location and the special trade and investment relationships that have developed historically, we necessarily held a special position vis-à-vis the U.S. This special status was further enhanced in that we were the main beneficiaries - in terms of the advantages of U.S. defense protection and access to U.S. capital and markets - of the implicit bargain between the U.S. and its partners even though we emerged from the war with a much stronger economy than in 1940 and in much better shape than the economies of Western Europe and Japan. By associating ourselves with the rest of the world and strongly endorsing a multilateral non-discriminatory international economic system we were able to take full advantage of the concessions made by the U.S. and to gear the rate at which we made concessions to the rates acceptable to the rest of the world. In addition, we were able to resolve many bilateral questions internationally rather than through direct bilateral negotiations, thereby minimizing the frictions and emotions that bilateral bargaining may easily arouse. At the same time, Canada could be reasonably confident of being able to work out special arrangements with the U.S. when special problems arose as in the case of exemption from U.S. balance of payments guidelines in the 1960's and the auto pact.

During the past decade the picture has been changing for a number of reasons. For one thing, further progress toward a freer, multilateral, non-discriminatory international economic system has slowed, if not halted, as a consequence of the advent of the E.E.C., the growing resort to non-tariff trade barriers, the demand for tariff preferences by developing countries and the apparent reluctance of most countries to undertake further reductions in trade and payments barriers. Moreover, within the U.S. a feeling has evidently been growing that in the past foreigners have taken advantage of U.S. generosity and political concerns and that in future a tougher stance is warranted, giving greater priority to direct U.S. economic interests. In addition, the U.S. recently has exhibited a growing preoccupation with large issues and its relations with the other major power centres - Europe, Japan, the U.S.S.R. and China - and less interest in tangential concerns, peripheral areas and special cases. On the Canadian side these developments have been reinforced not only by growing concern about our very heavy dependence on the U.S. and our vulnerability to U.S. policy changes but also by growing doubts about our failure to adopt more clearly defined industrialization policies than in the past.

Because of these and other developments many Canadians have recently come to believe that Canada in future will need to, and possibly should, fend for itself to a much greater degree than in the past in its relations with the U.S. and the rest of the world. This, in turn, has given rise to feelings of greater isolation and uncertainty. It appears, for example, that in future we cannot be as confident as we once were of working out special arrangements with the U.S. on particular problems - as witness the August measures. And in some minds, it is not deemed very appropriate that we should claim special treatment every time we run into trouble when at the same time we continue to preach the need for greater independence.

The sense of having to make our own way in our external relations to a greater extent than before has several implications. For one thing, it may mean that we will try to develop a much clearer sense than in the past of the relative costs and benefits of various policy strategies and of bargaining concessions. Perhaps the day is gone when Canada could hope to reap substantial gains as a bystander, making a relatively small contribution itself, from the trade and payments concessions worked out between Europe and the U.S. Secondly, successful negotiation with the U.S. in future may mean having clearer ideas than in the past about the sources of strength in our bargaining position and being able to exploit these toughly and skilfully to achieve our objectives. This, in turn, could well imply greater political tension between the two countries than hitherto. Thirdly, it will probably be more costly in future to make concessions to starry-eyed economic nationalists than in the past. Not only may it be less feasible to escape from the consequences of such concessions under an umbrella of multilateralism but also such concessions may jeopardize seriously our bargaining position with the U.S. Fourthly, it may mean playing a more active role in promoting forward progress in the development of a freer multilateral and non-discriminatory international economic system, as envisaged by the Williams Commission in the U.S. for example - "the elimination of all barriers to international trade and capital movements within 25 years". Fifthly, it bears emphasis that there is little scope for Canada to bolster its bargaining position with tacit or overt threats of retaliation, since most retaliatory actions that Canada might contemplate have much more harmful economic effects on Canada than on the U.S. Finally, it is important for Canada to remain on a floating exchange rate in order to maximize its ability to adjust as easily as possible to external economic perturbations. Adoption of any new international monetary arrangements that might substantially curb the flexibility of Canada's exchange rate could well prove costly.

In recent months a number of commentators have posed the proposition that the August measures herald a new environment calling for fundamental adjustments in Canadian economic policy. Exactly what these adjustments should be is usually left very unclear, but implicit in much of the discussion is the suggestion that Canada should strive for greater self-sufficiency with respect to both foreign capital and trade as a means of fortifying its bargaining position relative to the U.S. and fostering its economic development. This analysis is fundamentally wrong. The change in Canada's international economic relationships has not sprung from the August measures but from more basic changes in world economic relationships. More important perhaps, in the new environment in which we find ourselves, any attempt by Canada to move towards greater self-sufficiency is more likely to weaken than to strengthen our bargaining position with the U.S. and is more likely to reduce than to enhance our economic prosperity. The August measures have made little difference to the economic basis for mutually beneficial trade and investment between Canada and the U.S. By exploiting these opportunities to the full both countries will have a greater incentive to maintain mutually satisfactory economic relationships than if the gains from trade and investment are curbed by a retreat into autarky.

Two further suggestions frequently implied by the call for a new policy approach are that Canada should put greater emphasis on its relationships with countries outside of North America and that it should consider reshaping its industrial strategy in some undefined way to adapt to the change in our relationship with the U.S. Although both suggestions are unexceptionable as they stand, both beg more questions than they answer. It has, after all, been mainly the rest of the world, rather than the U.S., that has withdrawn into regionalism, preferences and administrative controls, thereby impairing the multilateral non-discriminatory international economic system favoured by both the U.S. and Canada. As for reshaping our industrial strategy, nothing happened in August to alter the basic lines of comparative advantage between Canada and other countries that provide the basis for mutually benefical trade and investment. To the extent that there are opportunities to exploit these lines of comparative advantage more fully than in the past they obviously might be pursued. But this is more likely to enhance than to curb the mutual interdependence between the U.S. and Canadian economies.

Recent Canadian Policy

The response of the Canadian Government to the August measures in my judgement was largely correct. Initially, and in my view quite rightly, the Canadian Government attempted to gain exemption from the surtax and the discriminatory investment tax credit on the ground that the rationale put forward for these measures did not apply to Canada and that Canada's special relationship should be given priority over commitments under the GATT rules. This was rejected by the U.S., at least partly on the spurious grounds that Canada in 1962 applied a similar surtax to the U.S. as well as to other countries - spurious because in 1962 Canada was fending off a speculative attack on its fixed exchange rate whereas in 1971 the U.S. was trying to use its surtax to force a realignment of currencies other than the Canadian dollar which had already been revalued.

Having failed in this attempt, the Canadian Government then proceeded to improve its adjustment assistance arrangements to limit the worst effects of the August measures on particular industries. And it participated actively as a member of the Group of Ten to achieve the settlement arrived at in December.

The main features of this settlement were as follows:

a) the U.S. surtax and the discriminatory feature of the investment tax credit were rescinded;

b) the U.S. undertook to ask Congress to raise the nominal price of gold in terms of U.S. dollars by 8.6 per cent contingent on satisfactory trade concessions by the E.E.C., Japan and Canada; but the dollar apparently will remain inconvertible internationally into gold at this new price;

c) a new set of exchange rate parities was established for the currencies of most industrialized countries, under which (i) these currencies, on average, appreciated by about 12 per cent relative to the U.S. dollar and (ii) the band for free fluctuation in exchange values around the agreed parities was broadened from 2 to 4½ per cent.

d) the Canadian dollar continued to float in response to market forces;

e) the Group agreed to continue its consideration of the longer-term aspects of monetary reform in conjunction with the IMF.

From Canada's standpoint this may be viewed as a satisfactory outcome. Except for the DISC, the protectionist features of the August measures have been removed. Their removal has not been linked to negotiations on the auto pact, tourist allowances, defense-sharing arrangements and other outstanding issues between the two countries. The Canadian dollar continues to float, and because of the appreciation in European and Japanese exchange rates, Canadian producers are placed in a stronger competitive position both at home and abroad relative to producers in Europe and Japan.

Exactly what impact the DISC proposal may have on Canada is uncertain for at least three reasons. First, to the extent that multinational firms engaging in foreign investment take advantage of "tax havens", they already enjoy the tax advantage offered by DISC; the response of such investors will therefore probably be limited. Second, and abstracting from "tax haven" complications, the tax advantages arising from DISC on exporting from the U.S., compared to production in Canada, in most cases will be offset in some measure, and perhaps entirely, by the disadvantage of having to absorb all or part of the tariff levied on imports by Canada. Thirdly, a substantial body of evidence suggests that there are strong incentives for foreign producers of many manufactured products - especially technically-advanced products or products requiring follow-up service - to locate production facilities within the markets they serve rather than to serve these markets from abroad. In evaluating these effects it must also be remembered that under a floating exchange rate the impact of this measure will be at least partially compensated for by exchange rate adjustments. For example, if as a result of DISC, net capital flows into Canada tend to be less than they would otherwise be and if imports tend to be more relative to exports, the effect will be to put downward pressure on the exchange rate. Any resulting depreciation in the exchange rate, will, in turn, tend to enhance our competitive position abroad and to make the prospect of investment in Canada more attractive.

The December settlement dealt with the immediate issues of currency realignment and removal of the temporary U.S. trade restrictions announced in August. Contrary to much popular opinion, it did not dethrone the U.S. dollar as a reserve currency; it is gold that remains dethroned as long as the dollar remains inconvertible. Furthermore, the longer-term question of monetary reform now remains much the same as before August, 1971. The December settlement made little or no direct contribution to such questions as the appropriate degree of exchange rate flexibility, currency convertibility, the future role of gold, reserve currencies and special drawing rights, and the maintenance of a suitable volume of international liquidity.

Writing at the end of 1971, one senses that the events of the past six months may well seem less ominous in retrospect than they seemed at the time. All the same, it is evident that the August measures, combined with continuing high levels of unemployment, have prompted more serious reconsideration of Canada's position in the world economy, of our bargaining strengths and weaknesses and of our economic policies and industrial strategy generally than anything else in recent history. What policies Canada should adopt for the future depends very much on how one sees the outlook for the world economy. If the U.S. initiatives in August did in fact provide a springboard for further progress in reducing barriers to international trade, payments and investment, the consequence is likely to be an acceleration in the already extensive integration of world markets for goods, services and capital. On the trade side this implies that particularly large increases can be expected in trade in manufactures and services as well as in industrial materials. On the capital side the rapid increase in international capital flows experienced during the past decade may be expected to continue together with a continuing increase in role of large-scale international enterprises and direct investment. Moreover, in these increasingly competitive international markets the flows of goods, services and capital may well become more diversified than in the past with respect to source, destination and form.

For Canada, the objectives to be achieved within a more closely integrated and more highly competitive world economy are likely to remain much the same as they have always been. One central objective will be not only to provide a rapidly growing number of jobs to absorb large annual increases in the labour force but also to provide for jobs that yield acceptable increases in living standards, offer scope for applying the talent and training found in the population, and cater to its predisposition to live in the urban and more industrialized parts of the country. Associated with this is likely to be a growing demand for foreign goods and services by both consumers and producers for reasons of price, quality and variety. And the need to create more and better jobs, to develop specialized industry capable of surviving in more competitive international markets and to cater to more sophisticated domestic and foreign demands for goods and services will make it important to continue to have relatively inexpensive access to foreign investment and its attendant advantage of technology, management skills, market access, information and so on.

If one accepts this general outlook for the future, one may conclude that the important questions facing Canada at present are not how to insulate ourselves more effectively from developments in the rest of the world and how to reduce our dependence upon foreign trade and investment. Rather than try to resist the tide, it will be more useful to focus on how the Canadian economy can best be guided into even closer integration with the world economy, including the U.S., and how the costs of transitional adjustments, as the process evolves, as well as the costs of closer integration, as it is achieved, can best be minimized.

A key question that is likely to arise in various guises as these issues are addressed is how actively the Government should intervene in shaping the economy and to what extent it should rely on private competitive market forces. The case for Government intervention rests essentially on the existence of "external" economies and diseconomies which, because they are not fully reflected in private valuations, are not adequately reflected in the play of ordinary market forces. Unfortunately, very little is known about such externalities: this is very much a no-man's land of contemporary public policy where sense and nonsense are difficult, and frequently impossible, to distinguish; where discussion proceeds largely on the basis of assumption and assertion rather than analysis and evidence; and where narrow political and economic vested interests flourish. Substantially greater public investment in more and better information and analysis will be required to limit the range of uncertainty as much as possible. Even so, considerable ambiguity can be expected to remain.

Although recent international developments have created problems, they have also created opportunities for regaining the initiative in moving towards a more liberal international economic system. If these opportunities are to be as fully realized as they might, it is important that both Canada and the U.S. keep their eyes firmly fixed on this objective and not allow their vision to be dimmed by a series of subsidiary concerns. In addition, it is important that the U.S. provide strong leadership in pointing the way towards this objective rather than allow the initiative to pass into the hands of protectionists within the U.S. and abroad. And it is equally important that Canada support this leadership, not uncritically, but firmly and constructively.